# No. 13,239

IN THE

# United States Court of Appeals

## For the Ninth Circuit

BEN A. PUENTE and MARION PUENTE,
*Petitioners,*

vs.

COMMISSIONER OF INTERNAL REVENUE,
*Respondent.*

On Petition to Review a Decision of The Tax Court of the United States.

## REPLY BRIEF FOR PETITIONERS.

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### PRELIMINARY STATEMENT.

As disclosed in their respective opening briefs the parties to this proceeding are substantially in accord as to the jurisdiction of this Court, the facts involved, and the question presented for the Court's determination. Cf. pages 1 to 4 of the petitioners' opening brief and pages 1 to 3 of the respondent's brief.

## ARGUMENT.

### I. THE RESPONDENT'S ARGUMENTS ON PRECEDENTS IN COURTS OF APPEALS ARE MISLEADING.

In the petitioners' opening brief the force of four opinions in United States Courts of Appeals for other circuits in favor of the respondent has been freely admitted, and this Court has been asked to go contrary to those opinions on the basis of the petitioners' arguments throughout their opening brief that they were wrongly decided. In the respondent's argument under his Proposition A, pp. 5-8 of his brief, he has imported two additions to the list of adverse decisions. One of these, *Smith v. United States,* 180 F. (2d) 357 (C.A. 6, 1950), affirming *per curiam* 85 F. Supp. 838 (D. C. W. D. Tenn., 1948), is properly mentioned in connection with the question here involved. Examination of the facts found by the District Court indicates, however, that factually the case is a borderline one, the taxpayer's only business having been the operation and management through agents of an apartment house for the production of rent income. The other case so imported, *Merrill v. Commissioner,* 173 F. (2d) 310 (C.A. 2, 1949), does not involve in any way the sale of property or equipment used in business. The statement, p. 6 of the respondent's brief that the petitioners "assert that *all* of these cases were erroneously decided" is patently inapplicable to any position of the petitioners with respect to the *Merrill* case.

Contrary to the implication in the respondent's statement, the petitioners agree that the *Merrill* case was expertly decided on the basis of careful analysis

of the language and intent of the terms of section 122, Internal Revenue Code. It is, indeed, hard to understand how the same Court, having a related but different question before it in the case of *Baruch v. Commissioner,* 178 F. (2d) 402, not quite ten months later, disposed of it so summarily on consideration of a brief for the petitioner *Baruch* which brief has been the model of the arguments for the petitioners in the instant case. There is certainly nothing in the *Merrill* case decision which would have been inconsistent with a decision in Mr. Baruch's favor. For the respondent to emphasize the merits of the *Merrill* decision as being a well considered one, *which it was,* on the question here involved, *which it was not,* is plainly misleading as to any bearing that case may have on the question here involved.

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## II. THE RESPONDENT'S EXEGESIS OF SECTION 122(d)(5) IS FAULTY.

In his argument under Proposition B on the construction of the phrase "not attributable to the operation of a trade or business regularly carried on", pp. 8 to 12 of his brief, the respondent insists that the emphasis should be on the word *"operation"* and that the word *"attributable"* should be treated as a mere connective. Such argument is contrary to the rule of construction that all the words of the statute should be given their usual and ordinary meaning to effectuate the indicated purpose of the legislature. He would have this Court give paramount significance to the word *"operation"* which is only one word in a

sub-phrase, "operation of a trade or business regularly carried on", to the detriment of the word "attributable". That plea is merely a restatement of the thesis of the respondent's ruling in I.T. 3711, C.B. 1945, p. 162, a critical analysis of which is printed on pp. 16 to 22 of the petitioners' opening brief. The respondent does not, indeed, defend in his brief either the argument or the alleged "authorities" of I.T. 3711 but he does attempt in his argument to muddle the interpretation of the comparatively simple phrase under discussion by a reference to the opinion in *Hartley v. Commissioner,* 72 F. (2d) 352 (C.C.A. 8, 1934) which merely holds that a deduction for Federal Estate taxes paid (deductible for income tax purposes under Section 214(a)(4) of the Revenue Act of 1924) were not includible in a net operating loss.

For the rest of his argument under the subject Proposition B the respondent merely begs the question by attributing to the petitioners arguments not actually made by them, and then demolishing such assumed arguments to his own satisfaction. The petitioners, for instance, never have contended, with respect to the losses on their sales of cattle and equipment, that such sales were anything but liquidating sales which were the final transactions of their dairy business, fully *attributable,* however, by way of cause and effect, to the beginning, middle, and end of the operation of such business.

The petitioners' argument under their Proposition IV, which the respondent appropriately refers to in his proposition on the construction of the crucial

phase of Section 122(d)(5), from the distinctions between the three classes of losses covered by Section 23(e), far from being fallacious in "that it ignores the fundamental difference in the language and purpose of the two sections", is apposite to the problem of construction. This is so because of the definition of "net operating loss" in Section 122(a), copied at p. 23 in the appendix to the respondent's brief. By that definition any deduction allowable under Section 23(e)(1) as "incurred in trade or business" is a part of the "net operating loss" unless ruled out by the excepting terms of Section 122(d)(5). That brings us right back to the point at issue here, whether the term "attributable to the operation of a trade or business" is inclusive or exclusive of a deduction for a loss "incurred in trade or business".

The respondent does not deny that the losses here in question were subject to the provisions of Section 117(j)(1) and (2), Internal Revenue Code, and of Section 23(e)(1), *idem,* insofar as the petitioners' taxable income for 1945 is concerned.

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### III. THE RESPONDENT HAS FAILED TO OVERCOME THE PETITIONERS' ARGUMENTS FROM THE HISTORY OF NET OPERATING LOSS PROVISIONS OF THE INCOME TAX LAW.

Under Propositions C and D of the respondent's brief he has attempted to answer the petitioners' argument under their Proposition II that "the history of the net operating loss provisions of the Income Tax Law indicates no intention to exclude from 'the net

operating loss' losses incurred in the disposal of assets used in the trade or business''.

His argument under Proposition C is more eloquent in what it omits than in what it says. Discussion of the case of *Auburn and Alton Coal Co. v. United States,* 61 Ct. Cls. 438, a 1926 decision under Section 204(a), Revenue Act of 1918, is pointless for the reason that that section does not define a net operating loss by a specific reference, as in the Revenue Acts of 1924, 1926 and 1928 and in Section 122(a) of the Internal Revenue Code, to the excess of deductions allowed by the Income Tax law over gross income, with certain exceptions and limitations. Cf. the paraphrases of the provisions of Section 206(a), Revenue Act of 1924, at p. 17 of the respondent's brief and at p. 10 of the petitioners' brief.

The respondent's discussion of cases under Section 204(a) of the Revenue Act of 1921 for the inclusion in net operating losses of ''losses sustained from the sale or other disposition of real estate, machinery, and other capital assets'', the respondent means to give the impression that such losses were thereafter excluded, such impression would be entirely false. The definition of ''net loss'' or ''net operating loss'' in the Revenue Act of 1924 and in subsequent statutes as the excess of allowable deductions over gross income automatically took care of deductions for such losses as had been specifically included in the definition in Section 204(a) of the 1921 Act. The treatment of such losses varied however with the mutations in the definition of ''capital assets'' in the income tax law.

CORRECTION OF SECOND PARAGRAPH PAGE 6

Matter omitted in printing is included in brackets below.

The respondents discussion of cases under Section 204(a) of the Revenue Act of 1921 [likewise does not develop any matter contrary to the petitioners' conclusions. If, in mentioning on p. 15 and again on p. 17, the provisions of Section 204(a) of the Revenue Act of 1921] for the inclusion in net operating losses of "losses sustained from the sale or other dispositonn of real estate machinery or other capital Assets", the respondent means to give the impression that such losses were thereafter excluded, such impression would be entirely false.

operating loss' losses incurred in the disposal of assets used in the trade or business.

The argument under Proposition [illegible] is more [illegible] in what it omits than in what it says. Discussion of the case of *Auburn and [illegible] Coal Co.* v. *United States*, 61 Ct. Cls. 538 (1926) decided under Section 204(a), Revenue Act of 1921, is pointless for the reason that that section does not define "net operating loss" by a specific reference as do the Revenue Acts of 1924, 1926 and 1928 and in Section 122(a) of the Internal Revenue Code, as the excess of deductions allowed by the income tax law over gross income with certain exceptions and limitations. Cf. the paraphrases of the provisions of § 206, [illegible], Revenue Act of 1924, at page 17 of the respondent's brief and at p. 10 of the petitioner's brief.

The respondent's discussion of cases under Section 204(a) of the Revenue Act of 1921 for the inclusion in net operating losses of "losses sustained from the sale or other disposition of real estate, machinery, and other capital assets". The respondent attempts to give the impression that such losses were thereafter excluded; such impression would be wholly false. The definition of "net loss" or "net operating loss" in the Revenue Act of 1924 and in subsequent statutes as the excess of allowable deductions over gross income automatically took care of the inclusion of such losses as had been specifically included in the definition of Section 204(a) of the 1921 Act. The treatment of such losses varied however with the mutations in the definition of "capital assets" in the income tax laws.

In his references to *Dalton v. Bowers,* 287 U.S. 404 (1932), 53 S.Ct. 205, 77 L.Ed. 389, and to the same case in the Circuit Court of Appeals, 56 F. (2d) 16, the respondent, like Judge Leech in his opinions in *Joseph Sic,* 10 T.C. 1096 (1948), (Cf. petitioners' brief p. 23) overlooks the only important point in these opinions relating to the instant problem, *viz.* the approval, specific at 56 F. (2d) 18, and implied in the Supreme Court's opinion, of the provisions of Art. 1621, Income Tax Regulations 65, which are substantially like those of Art. 651, Regulations 74, quoted on p. 11 of the petitioners' opening brief. The specific issue regarding a loss on corporation stock settled in the *Dalton* case is so little like the issue as to the losses sustained by the petitioners, that the Court's decision on that issue is of no assistance here. The approval of Art. 1621, Regulations 65, is, however, significant.

In his argument under his Proposition D the respondent not only fails to acknowledge the force of the approval of his regulations under the pre-Depression Revenue Acts in the *Dalton* case, supra, but actually avoids the issue by calling attention to the failure of the petitioners to repeat on page 16 of their opening brief matter from Art. 651, Regulations 74, which had been printed in full on page 11 of the same brief. The losses on sales of dairy stock and farm equipment here involved are *ordinary,* not capital, losses under the provisions of Section 117(j), Internal Revenue Code. The plain implication of the quoted paragraph of Art. 651 is that they would have been

ordinary losses under the provisions of the Revenue Act of 1928. However, the provisions for exclusion of net capital losses, whatever their definition, from net operating losses are similar under the 1928 Act and the present statute. The details of such provisions as they existed in the 1928 Act or in subsequent statutes have no bearing whatever on the issue in this case.

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## IV. THE RESPONDENT HAS FAILED TO OVERCOME THE PETITIONERS' ARGUMENTS ON PARITY OF INDIVIDUALS AND CORPORATIONS WITH RESPECT TO LOSSES ON DISPOSAL OF PROPERTY USED IN TRADE OR BUSINESS.

In the respondent's arguments under his Proposition E, pp. 20 and 21 of his brief, against the grounds for the petitioners' Proposition IV, pp. 24-28 of their brief, he does not dispute the obvious effect of the provisions of Section 23(f), Internal Revenue Code, to treat all losses of Corporations as losses incurred in trade or business. Because, under the provisions of Section 117(j), which is applicable alike to corporations and individuals, losses on sales or other disposition of property, including real estate, used in trade or business are ordinary losses, there are, by virtue of the inclusive quality of Section 23(f), no substantial problems involving the effect of such losses on the computation of "net operating losses", and only in frequent cases in the Courts concerning corporations' net operating loss deductions. The only two cases discoverable which touched on the point were cited in the petitioners' brief, p. 24. The distinctions pointed out in the respondent's brief, pp. 20,

21, respecting those cases, do not in any manner weaken the fact that the income tax law allows, by the force of Sections 23(f), 117(j), and 122(a) the inclusion in a corporation's "net operating loss" losses on the disposal of assets used in its trade or business. Since, with regard to individuals Section 23(e)(1) of the same statute is the equivalent of Section 23(f) affecting corporations, Section 117(j) losses, which are allowable under Section 23(f) or Section 23(e)(1), as the case may be, are includible in the definition of "net operating loss" by Section 122(a) without distinction of a taxpayer as individual or corporation. What the respondent says about these similarities, which were pointed out in the petitioners' brief under their Proposition IV, is *nil.* What, indeed, could he say, other than to admit the effect of the plain provisions of the statute?

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## CONCLUSION.

For the reasons set forth in the petitioners' opening brief, which, as demonstrated above, the respondent has in the arguments in his brief failed to overcome, the petitioners pray that the decision of The Tax Court subject of this proceeding be reversed.

Dated, Stockton, California,
May 28, 1952.

Respectfully submitted,

LAFAYETTE J. SMALLPAGE,
*Attorney for Petitioners.*